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WEITERE INFORMATIONEN OK

An unending variety of topics

Tuesday, April 22, 2008

The "hoarding" and "speculation" in commodities

It is a gross violation of Occam's Razor to attribute the recent very broad-based run-up in dollar commodity prices primarily to the plethora of disparate causes to which they have been attributed: "peak oil", the war in Iraq, ethanol subsidies displacing food, and so on. Rises in industrial demand, increases in the costs of transporting commodities due to high oil prices, and so on explain only a small fraction of the rise in other commodity prices, and do not explain at all why precious metal prices have increased alongside those of other commodities. Occam's Razor points us, as it did to wise investors and economists in the 1970s, to the one kind of commodity all these other commodities have in common: the currencies they are priced in.

In the 1980s, there were just as many of these disparate bullish factors for commodities as in the 1970s and as today. In the 1980s there was increasing industrial demand in Asia and the developing world, and the Iran/Iraq war drove insurance rates for oil tankers in the Persian Gulf into the stratosphere, yet commodity prices in dollars and dollar-linked currencies broadly fell, due to the emphasis of the Federal Reserve on fighting inflation throughout the 1980s.

Commodity prices now reflect more the value of commodities as stores of value and hedges or media of exchange, i.e. their values as money substitutes or hedges, than they reflect demand for their industrial consumption. The trend lines for global industrial demand have not really changed that much -- the increases in Asia are largely offset by slower demand growth in Europe and the U.S., and at today's high prices we will see industrial demand slowly fall in the U.S. and Europe and level off in Asia.

But demand for the oft-dreaded but ill-understood "hoarding" and "speculation", that is storing extra commodities (often off-the-books, or at least not in the officially measured warehouses) and the purchase of extra commodity futures and other commodity derivatives to hedge transactions based on government currencies, will remain strong as long as the Federal Reserve continues to inflate the dollar supply, and as long as many developing countries continue to link their currencies to this dollar. Commodity prices in dollars will level off, and then move back down close to historical trends based largely on just industrial consumption, if or when the Fed stops increasing the supply of dollars faster than the demand for dollars. If the Fed continues trying to inflate its way out of the latest bubble-following slump, commodities will not be the next bubble: instead they will form the basis of the new de facto currencies of high finance. See

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Nick Szabo

"A premier thinker about history, law and economics, and the lessons they have for security." -- Adam Shostack, Emergent Chaos

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Commodity derivatives: the new currencies

Obviously the euro also plays a big role, but it is important to observe that the euro too has inflated, just to a lesser degree than the dollar. The euro has not developed the track record that would make many international investors think euro-denominated debt does not need to be hedged with commodity derivatives. Some wise investors still remember the hyper-inflations and outright defaults of the late 1920s and early 1930s that made many government bonds almost worthless, the destruction in the value of the U.S. debt in the 1970s from inflation, and many similar episodes. In these circumstances commodities are usually safer than government debt denominated in the fiat currencies of the same governments that owe that debt.

That's why the current flight to safety involves commodities as much or more than it involves government debt, and indeed the debts of less robust governments (ranging from municipalities in developed countries to the national debts of less developed countries) are no longer considered safe. It is well known by now that U.S. Treasuries are "safe deposit boxes" that pay negative real rates of interest -- i.e. one must pay for the privilege of storing one's wealth in a form backed by the vast future revenues of the IRS. They are a way losing one's wealth with less rapidity and volatility than with many alternative investments, not a way of actually building wealth. Commodities also store rather than build wealth. By contrast to Treasuries, commodities are more volatile, but are not subject to unknown future amounts of fiat currency inflation. A mix of U.S. Treasuries, European debt, and commodity derivatives now forms the ideal safe "store the cash under your bed" portfolio. Government debt alone is far too risky during periods when central banks are not strongly committed to reigning in money supplies.

[The above is based on comments I made at the Marginal Revolution blog].

Posted by Nick Szabo at 4:12 PM

18 comments:

nick said...

Here's a follow-on comment I made at Marginal Revolution (slightly revised and extended here), in response to the following quote by one "M1EK" to try to explain why oil prices were low in the 1980s and 1990s: "in the 1980s the Saudis had capacity they could bring online at any moment (and eventually did, of course)."

To this I respond:

The same was true in the 1970s and is true today, and people in the oil business are well aware of this and it is properly reflected in the current price. Nothing has magically changed about the geology of oil in the ten years since oil was $20 a barrel. And not only Saudis, but Russia, Iraq, Venezuala, and Mexico are all pumping well below their potential (mostly for monetary reasons which I explain below), and will still have plenty of oil around decades into the future. And in that time most of the following -- Canadian tar sands, U.S. shale oil, deep sea oil, coal gasification, biofuels, nuclear, wind, solar, and conservation -- will make a big dent in the consumption demand for oil. As purely economics 101 matter of supply and demand for consumption, the value of oil for consumption will likely decrease in future decades. That of course doesn't say much about what the dollar price of oil will do, but I can say with confidence that if oil keeps rising it will be due to monetary factors, and in particular continued growth of the dollar and euro supply beyond the demand for dollars and euros. Oil will not rise due to traditionally recognized supply and consumption demand factors, in fact due to the current overinvestments in oil and alternative energies the percentage of the oil price attributable to such "fundamentals" will continue to decrease.

We often live under a grand illusion that that the dollar is a stable standard of value and thus the dollar prices for commodities

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provide an accurate measure of supply and consumption demand for those commodities. They don't, and it's not even close. The supply and demand for the dollars is the far more dominant factor, and on top of that the demand for commodities as money rather than for consumption becomes, in times of inflation, much more important than "fundamentals." Those who just look at dollar prices have a wildly distorted view of economic reality.

Oil prices today reflect the best consensus estimate of what oil prices will be in the future. Regardless of how high oil prices get, they don't provide substantially more incentive to pump, because how high they are today doesn't say anything more than low prices about whether prices will be higher or lower five years from now. These commodities behave very differently from a widget where you either make it now or lose the sale. Furthermore, oil prices in terms of other commodities have not risen substantially, and the oil companies and countries understand that their increased wealth as measured in dollars or euros is partly an illusion (because its is the value of the dollar and to a lesser extent the euro that has dropped, not value for consumption of oil that has increased) and partly a matter of extra demand for commodities as money that would disappear if the Fed got its act together, as it did in the 1980s and 1990s.

The monetary function of commodities can be seen from all the dreaded hoarding that is going on. With the failure of the dollar people need extra commodities in the "vault", even if these vaults are just the pantries of third-world families or the warehouses of governments.

Oil is mostly not hoarded directly above ground, because it is much more expensive to store above ground than to just keep it in the ground to pump later. When oil futures are used as money, this discourages pumping, despite the high oil prices, and that's exactly what we're seeing. If oil had no monetary function we'd see a huge increase in pumping, but instead we're seeing oil hoarding in the form keeping the oil in the ground and selling more oil futures backed by that unpumped oil. Practically all major oil countries are currently pumping below their potential output, and it is again a gross violation of Occam's Razor to explain this as a matter of a wide variety of political problems that just happen to all be occuring at the same time. These countries on average have no more political problems than they did during the 1980s and 1990s. They are under-pumping because the demand for oil as money, that is as backing for oil futures and other oil derivatives, dictates that more oil be stored relative to consumption, and that this oil be stored in the lowest cost way, i.e. that it be kept in the ground.

There are probably more than $10 trillion worth of commodity derivatives outstanding today, a vast increase over less than $2 trillion five years ago. Nothing like this volume of derivatives are needed to simply hedge commodity production and consumption. Instead this volume is demanded for use as a money substitutes or to, equivalently, hedge assets denominated in government currencies. It's much like fractional reserve banking -- commodity derivatives are a money substitute or hedge based on a much smaller value of commodities that have to be "stored in the vault" for use at "redemption windows", especially in cases of "runs on the bank." During such runs we will see big spikes in commodity prices completely unrelated to commodity "fundamentals." Indeed, we've likely seen something like that during the recent and still ongoing credit crunch. (The comparison to fractional reserve banking is, of course, just analogical -- modern commodity derivatives markets are their own beast, and perhaps not well understood by anybody, but I think this analogy gives as good an insight as anybody has into what is going on).

Oil prices have also been driven up by the above-ground hoarding of more storable commodities, again because these commodities are increasingly being used as a substitute for the dollar and the many dollar-linked currencies. This increases the demand for such commodities, which increases the demand for oil used to produce the commodities. But this, like the direct excess demand for oil futures, goes away if or when the dollar resumes stability or another stable currency takes over from the dollar.

In short, we are increasingly seeing commodities used as a substitute for and hedge against dollars and dollar-linked currencies, and to a lesser extent as a substitute for euros, by a very wide range of people from third-world families and governments to the most sophisticated international traders. The recent large run-up in commodity prices is explained by this factor. Commodity prices will continue to reflect a strong demand for their use as a monetary substitute until the time when monetary policy becomes far less inflationary than it is now.

3:58 PM

Patrick said...

How can a perishable commodity serve as the backing for a currency? If I buy a gold ETF, the gold I buy ends up in a vault where it is stored in my name. If investors are trying to use wheat as a store of value, does that mean wheat inventories are building up somewhere? Doesn't the wheat spoil eventually? I'm guessing I'm missing something. Perhaps wheat producing land acts as the backing, and producing and storing the wheat is not actually necessary? (just as you claim pumping the oil is not necessary)

Thanks for any clarification. Your post was fascinating.

4:51 PM

nick said...

How can a perishable commodity serve as the backing for a currency?

There is a greater monetary price premium on those commodities with less storage costs (e.g. copper and other metals above or below ground, oil below ground) for this reason.

However, there has also arisen recently a hefty premium on grains, even though less storable, due to the same cause of the breakdown of the dollar and dollar-linked currencies. In less developed countries grains, although more perishable than metals, are being increasingly stored by people in areas where food is politically controlled (and thus might be politically witheld). Billions of people now lack *any* stable monetary alternative. They don't trust that they will be able to convert any other form of wealth in the near future to what they will most want to consume (i.e. food), and are thus insuring themselves by storing directly what they will want to consume, even though they incur somewhat higher storage costs than they would with other commodities. This, too, is a monetary phenomenon, although a pathological one, a return to barter, reflecting a breakdown of money without a good replacement for this segment of the world market. Storing food has high transaction costs, but those who spend large fractions of their savings on food have no ready alternative but to incur them.

In the sophisticated international markets, by contrast, there is a low transaction cost way to replace or augment government currencies, namely commodity derivatives. The government currency transactions being hedged by commodity futures are usually over shorter timeframes than the futures, so no expiration problem arises. Near expiration those holding for a longer term turn over the futures for later futures. There has actually developed a significant spread between the expiring future and the actual delivery price, due to the mismatch between the monetary demand for futures going well beyond the demand for actual consumption of those commodities, and the imperfection of arbitrage in responding to it in the face of transaction costs and the unfamiliarity of these recently developed commodity market conditions.

2:52 PM

Neil' said...

I agree that recent price spikes aren't just from "market fundamentals" applied to the latest demand over supply tensions. Much (how much hard to pin down?) comes from trading and hoarding. We shouldn't stand for our oil prices being gamed up by trading interests. Wouldn't a little sales tax on commodity transfers be a start at doing the trick? Finally, so many businesses are hurt by these prices that it isn't proles versus "the rich"/employers etc. We can find common cause with most productive Main Street businesses against the Wall Street trading/manipulating factions. IOW, we are fighting a powerful but actually very small minority over oil prices.

4:09 PM

nick said...

Much (how much hard to pin down?) comes from trading and hoarding. We shouldn't stand for our oil prices being gamed up by trading interests. Wouldn't a little sales tax on commodity transfers be a start at doing the trick?

Trading and hoarding are neither irrational nor inefficient, given the problems with the dollar and dollar-linked currencies. They are as good attempts as can be made to provide a substitute for the monetary functions of the dollar, i.e. to provide a store of value and

medium of exchange, or in the case of food stockpiling to make up for the expected lack of ability to change today's money for tommorrow's food. Slowing down the commodities market now would be like slowing down your immune system when you have the flu. It might reduce your fever for a while, but it will let the flu destroy you.

Treating the symptoms rather than the disease is, alas, quite popular. It occurred during the 1970s with WIN ("Whip Inflation Now") buttons, price controls, gasoline rationing, investments in energy conservation (Jimmy Carter in his nice thick wool sweater asking folks to please turn down their thermostats), and a wide variety of other such nonsense we see being repeated with slight variations today. Nothing worked until the Fed led by Paul Volker dared to reign in the supply of dollars, despite causing a recession in the process.

5:35 PM

Neil' said...

This comment has been removed by the author.

5:50 PM

Neil' said...

Sorry nick, but when you say "neither irrational nor inefficient" you mean only from the point of view of the traders doing that. The trouble is, the rest of us don't like how it affects us and want to stop those effects from happening. You can complain that we don't have the right to try or whatever, but here's an irony I notice in such discussions: someone talks about "self-interest" and then wants the readers to apply that to sympathizing with the self interest of the other party (usually some gamer just like under discussion.) But for us, "self-interest" is *our* self interest, not theirs. You talk about being destroyed by the flu, but why should I believe that *we* (the proles) would be destroyed by blocking these hoarding and trading games? It had better be a damn good benefit (and not by the fallacy of given the system, it would have to work like that because maybe we should do things very differently to start with) from our point of view, because we are paying a hell of a price for it.

5:52 PM

Patrick said...

Thanks for the reply about wheat!

Do you think the Fed can actually pull a Volker and raise interest rates to reduce inflation? It seems our level of debt now is far greater than the 1980's. Raising interest rates to 10+ percent would be pretty devastating. I'm not sure how the Fed gets us out of this.

Btw, where do you get your information about commodity derivatives being used as a hedge against currency risk? I read a lot of econ blogs, but nobody has ever mentioned that as possible theory about why commodity prices are going up. Yet somehow your theory sounds much more plausible than everything else I've read. I'd love to know what your sources of information are.

5:59 PM

nick said...

patrick: *Do you think the Fed can actually pull a Volker and raise interest rates to reduce inflation? It seems our level of debt now is far greater than the 1980's.*

The level of direct U.S. debt as a % of GDP is still far lower than at the end of WWII, although if we add in unaltered SS and Medicare liabilities it starts to rival that level. I expect SS and Medicare will be readily solved in various obscure ways, such as the low-balling

formula for CPI. So there's plenty of room to raise rates. It probably would take only about 6% nominal rate to make the commodities market tank (e.g. to get oil back to $40 per barrel).

My evidence for currency hedging is admittedly indirect or ambiguous. Indirect evidence includes the huge increase in commodity derivatives which can't be explained by traditional hedging. Ambiguous includes the hedging of expected future commodity purchases by traditional users of commodities (airlines, meat packers, etc.). These are hedges against potential price increases, as measured by current volatility, and there are no separate components for proving what portion of that volatility is due to monetary factors (naturally I think this is large) and what portion is due to traditional "fundamentals." My theory predicts that the proportion of hedged future purchases has increased, and the scope has increased (i.e. more kinds of goods are considered linked to commodity prices, including specific baskets of commodities used in making the good, and thus more of the expected future purchases of such goods are hedged, than five years ago).

4:55 PM

Patrick said...

Total government public debt, mortgage debt and credit card debt has gone from ~71% of GDP in 1980 to ~114% of GDP today. In 1950 government debt was high, but spending was much lower. Consumer and mortgage debt was a small fraction of what it is today. It would seem that a Volcker-like policy now would result in much more pain than it did in the early 1980's.

Are you sure that a 6% interest rate would do the trick? I have heard reasonable arguments that the current growth of the money supply is over 10% a year (usually the stat shown is M3 or MZM). If that's really the case, than holding on to assets would still be a better bet than buying a bond paying 6%. Also, if 6% is all that it would take, why did Volcker raise the rates so much higher than that?

7:56 PM

Patrick said...

Also note that in the late 40's and early 50's interest rates were even lower than they are now. The Fed could keep these rates low because it did not have to worry about smart money fleeing the dollar. Owning gold was illegal, derivatives did not exist, and the US dollar was the most trusted currency in the world.

8:17 PM

nick said...

patrick: *Consumer and mortgage debt was a small fraction of what it is today.*

We'll have to see just how much worse the housing crunch becomes. I observe that relative to commodities, U.S. housing prices have already dropped by more than half in just the last year. In euros the drop is less but still fairly large. But the commodity and euro value of mortgage liabilities has also fallen substantially: housing prices have only fallen about 10% faster than the face value of the mortgages. U.S. real estate is now becoming a very tempting bargain for foreigners flush with cash.

I have heard reasonable arguments that the current growth of the money supply is over 10% a year (usually the stat shown is M3 or MZM).

Yes, but demand for dollars has also grown over most of the last five years, at some unknown but probably lesser rate, and would grow again if the Fed got its act together. The 10% is probably just a temporary phase to get us through the current credit crunch. If the Fed gets its act together, the prerequisite for $40 a barrel oil, M3 growth would be reduced to match demand for the dollar, which means it might even have to shrink until such time as dollar demand revives. It's possible, but not probable, that the Fed will continue to behave pathologically such that M3 will keep growing in excess of demand for dollars for the next 30 years. In that case, we could easily reach and pass through $200, $300, etc. a barrel oil -- the sky's the limit. This huge uncertainty, a possible price

range between $40 and $300 or more a barrel, based on unpredictable Fed behavior, is the biggest reason for the recent surge of commodity derivatives and the growth of transaction and portfolio hedging with commodities.

If that's really the case, than holding on to assets would still be a better bet than buying a bond paying 6%.

But there are plenty of people who are buying Treasuries at 4.5%, implying that they expect dollar inflation to be lower than 4.5% for the next 30 years (or else that they are willing to pay a hefty negative real interest rate for the privilege of holding a safe security for the next 30 years). Granted, these people are increasingly hedging these bets with commodities, but nevertheless there is still a huge demand for Treasuries at prices predicting that they are quite secure and that inflation will not get out of hand.

if 6% is all that it would take, why did Volcker raise the rates so much higher than that?

Inflation had become far more advanced by the time Volker kicked in: gold had gone from $35/oz. to $800/oz., and the CPI and PPI had been over 10%/year for several years. Today gold has gone up only four-fold rather than twenty-fold over the last decade, and the CPI and PPI have been less than 3% until recently and are still less than 5% (albeit under a dubiously altered formula). My guess is that M3 had been growing beyond demand for at least 15 years, from 1965 to 1980, vs. about 5 years today. There was also a very high rate on Treasuries: reaching to the 20% range compared to 4.5% today. Back in the good old 1970s we heard all the extreme scenarios about the world running out of oil, metals, water, topsoil, etc. or the U.S. going bankrupt, that we are hearing now, so I'm quite skeptical of all such claims.

Also note that in the late 40's and early 50's interest rates were even lower than they are now. The Fed could keep these rates low because it did not have to worry about smart money fleeing the dollar. Owning gold was illegal, derivatives did not exist, and the US dollar was the most trusted currency in the world.

All good points. History never repeats itself exactly. But some of these changes are positive for us -- with computerized derivatives, for example, we can increasingly transact in weak currencies while holding net positions denominated in strong ones, including commodities. Bankers also have far more information about the health of the loans of their own and others than we had in the 1950s, and consumer debt is higher (and savings lower) because long-term inflationary expectations are much higher now than in the 1950s, so it's probable that a much higher level of consumer debt is rational and sustainable.

4:39 PM

Patrick said...

How do you measure dollar demand independently of commodity prices?

Here's my overall interpretation of events:

The money supply has been growing at 10+% a year due to the Fed subsidizing maturity mismatching. Holding dollar bills has an ROI of -10%, government bonds an ROI of -6%, and index funds and assets an ROI of about 0%.

Since interest rates are negative, it's rational to take out loans and buy assets, which is exactly what people have been doing. Investing in bonds is generally irrational, since the government is subsidizing borrowing. That's why investment advice books tell long term investors to stay away from bonds. The major purchasers of treasuries at 4.5% interest rates are other central banks, who are trying to hold off the reckoning. As Brad Setser writes:

Incidentally, the $8.7b in average weekly purchases of Treasuries over the last 8 weeks would – if sustained -- be enough to finance a $454b budget deficit without selling a single Treasury bond to private investors. Sometimes I think the US should drop the façade of auctioning off Treasuries and just negotiate private placements with the People's Bank of China and the Saudi Monetary Agency.

Asset prices determined by consumption demand, its monetary demand, and its marginal cost of production. What we are seeing is a

pattern of people using assets to hold savings, and then that asset getting over produced (eg internet stocks, housing in exburbs), prices dropping, then monetary demand dropping because the asset cannot hold savings. Only the assets that have limited supply (commodities, property in areas with heavy zoning restrictions) can hold savings long term.

As you point out, the rise of derivatives, ETFs and computerized transactions makes the transaction costs of using commodities as alternative currencies much lower. Also, if monetary demand for commodities is growing, the ROI of holding commodities becomes even more positive, generating even more demand. This is the bubble effect, except since supply is limited, there's no built in mechanism that eventually pops it.

To stop the run up in commodity prices the Fed will likely need to increase real interest rates from -6% to at least 0%. With our current levels of debt, this will be extremely painful. The only other solution is to increase the transaction costs of using commodities as alternative currencies. This will hold off the recession, but result in continued stagnation, asset bubbles, and malinvestment.

In summary, I think the inflation has been going on a lot longer than you think. People haven't noticed it because the bubbles have been in stocks and housing, which did not squeeze the common person as much. But now that the inflation has hit commodities, people are not happy.

2:22 PM

nick said...

patrick, one has to take into account the implied growth for demand for dollars over the same period. The strong market for U.S. Treasuries reflects continued growing demand for dollars, even if that demand is largely from sovereign funds buying dollar-denominated debts. I thus suspect the real interest rate on 30-year Treasuries, nominally 4.5%, is about 0%, reflecting excess growth of dollar supply over demand of 5.5%/year (given your figure of dollar supply growth of 10%/year). The nearer term Treasuries have slightly negative real rates, and Fed Funds are about -1.5%, which is enough to be highly inflationary, for the reasons you cite (the ongoing arbitrage of borrowing dollars to buy hard assets). We need a real interest rate of 3-6% on Fed Funds to stabilize the dollar. But any such analysis is sheer guesswork.

Now you could argue that the demand for dollars is being fed artificially by government debt and sovereign funds irrationally investing in that debt, but that's a different argument from saying that the real interest rate is -6% today. Per above I believe that the U.S. debt, though economically very harmful to ourselves and our children, is sustainable.

As for current account deficits cited by Brad Setser, I wonder how accurate they are. Do they take into account the vast foreign revenues from services (e.g. Google's booming overseas ad revenue) that are not counted as "exports"?

What we are seeing is a pattern of people using assets to hold savings, and then that asset getting over produced (eg internet stocks, housing in exburbs), prices dropping, then monetary demand dropping because the asset cannot hold savings.

This is a great observation, except I disagree with the last, because people keep finding more things to invest dollars in (most recently commodities and Treasuries).

Only the assets that have limited supply (commodities, property in areas with heavy zoning restrictions) can hold savings long term.

Even these can get soft, because over the long run commodities can be substituted and many people will move from high-price to low-price areas, or just not move into the high-price area in the first place when they get out of school.

Also, there is moral hazard in commodity derivatives just as with credit derivatives, and just as there was in gold-backed fractional reserve banking. I suspect housing will make a comeback.

The only other solution is to increase the transaction costs of using commodities as alternative currencies

This would be highly destructive, but alas there are many rabid politicians running around proposing just this.

FWIW here's my Extremely Uncustomized Recommended Portfolio:

50% stocks
30% real estate
20% commodities and collectibles

Only one customization: if you have major net expenditures coming up in the next 10 years (kids going to college, retirement, etc.), over half of the stocks should be sold and replaced with bonds and commodities as follows:

20% stocks
30% real estate
30% commodities and collectibles
20% bonds

Preferably you should live in the real estate and enjoy the collectibles as a hobby, so that you get utility as well as return from the investment.

Of course, real portfolios should be highly customized to your own preferences and expected future expenditures.

3:29 PM

Munin said...

Nick, you say "There has actually developed a significant spread between the expiring future and the actual delivery price"

Where's the evidence for this?

1:38 AM

nick said...

munin,

I've heard and read it from several news sources over the last few months, including here:

"The divergence between CBOT futures and the underlying commodity is so great that some grain merchants have stopped bidding for new crops, said Niemeyer, a member of the National Corn Growers Association board. Others won't guarantee a price for more than 60 days....

The price gap should converge when futures contracts expire and deliveries are settled. Instead, the average premium for CBOT wheat has quadrupled in two years to 40 cents a bushel, compared with 10 cents the prior five years, McNew said."

While I'm here, I should note my utter chagrin that a number of influential folks have *almost* reached the same conclusion as I, namely they've concluded that "speculation" not fundamentals are driving most of the commodities rise. But they stop there, repelled in horror by the idea, and don't take it a step farther -- ask *why* this "speculation" is going on. A good clue comes from those responsible for the biggest piece of it -- retirement funds. Retirement funds have long been heavy, relative to other kinds of funds, on less volatile (over <15 year periods) investments like bonds. But bonds are mostly denominated in dollars. With the threat of dollar inflation (obvious both from recent Fed activity as well as the history of the dollar in the 1970s) they have a fiduciary responsibility to protect their investors' retirement nest eggs by hedging bond positions with commodities baskets. And that is just what they have been doing.

(I suspect a similar explanation is behind much of the high Chinese demand -- but that rather than buying futures they are actually

stockpiling commodities, including cutting back on production of their own native minerals, to hedge their peg to the U.S. dollar, their massive dollar earnings from exports, and their heavy investments in U.S. Treasuries, all of which are vulnerable to dollar drop or inflation -- but I don't know where data on such stockpiling activity might be readily available).

Many of these retirement funds (who have been the dominant commodity index fund "speculators") can be politically influential. I wish, for the sake of the retirees they have a duty to protect, they would defend themselves politically against the insane proposals to restrict or ban commodity index funds. Those seeking to save for retirement have perfectly good and strong reasons for investing in commodity indices: they don't want to see their retirement funds eroded away by inflation, as happened to millions of seniors in the 1970s. Commodity indices have allowed people to construct retirement portfolios hedged against inflation, and this is an incredibly valuable thing both for the retirees and for the society on which said retirees will be less dependent. Instead of attacking the fever by shutting down the immune system, it is the original cause of the problem, the Federal Reserve, that needs to be addressed. It needs to put a higher priority on fighting inflation, and it needs to use leading indicators (e.g. commodity prices) far more than trailing indicators (e.g. CPI, PPI) in this task. (I understand of course that the credit crunch has been a very good reason for the Fed to "print dollars." That doesn't change the fact that the Fed is smack dab in the middle of the causal chain that has led to the commodities boom).

I should also say that it's certainly possible that some or much of the boom is a bubble. There is no easy way to gauge just how much retirement funds and others seeking to hedge inflation need to allocate to commodities baskets in order to optimize their portfolios, because it depends greatly on future Fed behavior. On the one hand we know that hyperinflation is a historical possibility; on the other hand the farther commodity prices go up (and they have gone up very far indeed) without corresponding inflation in other goods and services, the more downside price risk there is in commodities. It's certainly true that commodities have become a far riskier, i.e. more volatile, investment than they were three years ago, and that puts a severe limit on the proportion of an investment portfolio it makes sense to devote to commodities. It is often the case that economically efficient bull markets become overextended into wasteful bubbles, it being hard to tell how large of a price increase is actually warranted, and we may be seeing some of that now.

1:17 PM

Munin said...

Thanks Nick, glad to be of service. I'm new to this area, so sorry if this is a stupid question, but from the article you quote:

"the average premium for CBOT wheat has quadrupled in two years to 40 cents a bushel, compared with 10 cents the prior five years ... Wheat jumped to a record $13.495 a bushel in February, twice the level of a year earlier."

If I understand you correctly then the rising premium is evidence that prices are driven by monetary demand, rather than fundamentals. But the spread has increased by 30 cents over 5 years while wheat prices rose 650 cents in just one year.

To my untrained eye that would suggest monetary demand accounts for a relatively small proportion of recent price rises. What am I missing?

5:23 PM

Anonymous said...

plastic mesh plastic net bags protective sleeve plastic packaging net fencing & scaffold netting windbreak fencing barrier fencing mesh debris safety netting deer mesh fencing horticultural /agriculture turf reinforcement mesh window screen pea and bean net anti bird netting bop net & filteringpallet net wrap

10:51 PM

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